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On Behalf of the Edison Electric Institute

Before the Committee on Energy and Commerce
Subcommittee on Energy and Environment
United States House of Representatives

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Mr. Chairman and Members of the Subcommittee:

My name is Elizabeth ("Betsy") Moler, and I am Executive Vice President Government Affairs and Public Policy for Exelon Corporation. I appreciate the opportunity to appear before you today to testify about the impact of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, on organized energy markets.

Exelon is a public utility holding company headquartered in Chicago. Our local retail distribution utilities, Commonwealth Edison (ComEd), which serves northern Illinois and the City of Chicago, and PECO Energy, which serves southeastern Pennsylvania and the City of Philadelphia, together serve 5.4 million customers, or about 12 million people – more than any other utility company in the United States. Our competitive generation affiliate, Exelon Generation, owns and operates or controls over 30,000 megawatts of fossil, hydro, nuclear, and renewable generation facilities. Our nuclear fleet is the largest in the nation and the third largest in the world.

At Exelon, I head our company's Washington, D.C. office and serve as a member of Exelon's Executive Committee. I am responsible for all aspects of Exelon's federal government and regulatory affairs initiatives. I also serve as a member of the Commodity Futures Trading Commission's (CFTC) Energy and Environmental Markets Advisory Committee (EEMAC). Before joining Exelon, I spent 20 years on the Hill, served at the Federal Energy Regulatory Commission (FERC) for nearly 9 years under three Presidents as a Member and as the Chair, and as Deputy Secretary of Energy. I hope that my background as a public servant, and now as a utility executive, means that I have some insights that will be of interest to the Subcommittee.

I am testifying today on behalf of the Edison Electric Institute (EEI). EEI is the trade association of U.S. shareholder-owned electric companies, with international affiliates and industry associate members worldwide. The U.S. members of EEI serve 95 percent of the ultimate electricity customers in the shareholder-owned segment of the industry and represent about 70 percent of the total U.S. electric power industry. My examples and context are from Exelon's perspective but are representative of EEI members' concerns and requests.

My testimony today:

- Enumerates five points that a broad coalition of electric and natural gas companies believe should be included in any over-the-counter (OTC) derivatives reform legislation;

- Requests the Subcommittee to support amendments to H.R. 3795 to clearly establish FERC's plenary and exclusive jurisdiction over organized electricity markets and transactions; and

- Supports expanding the CFTC's jurisdiction to the new proposed markets for greenhouse gas allowances, including the OTC market.

EEI supports the goals of the Administration and Congress to improve transparency and stability in OTC derivatives markets. However, when crafting legislation for that purpose, it is essential that policymakers preserve the ability of electric and natural gas companies to use OTC energy derivatives products and markets for legitimate, important, and prudent business purposes. A large group of end-users has communicated this message to Congress on numerous occasions.[1] Utilities rely on these products and markets to manage wholesale electricity and natural gas price risk thereby helping keep rates stable and affordable for retail consumers.

When considering any increased regulation and requirements of OTC derivatives markets, it is important to note that end user commodity derivatives transactions do not involve or cause the type of systemic risk that Congress is seeking to eliminate through the proposed legislation. In fact, from a quantitative perspective, the entire commodities market is less than one percent of the global OTC derivatives market, and the energy commodity portion is only a fraction of that small percentage. Therefore, we believe that Congress should strike the proper balance in its regulatory reform efforts by establishing energy market oversight rules that allow for prudent use of OTC market-based risk management tools while also providing regulators with the tools needed to protect consumers against market manipulation and systemic risk.

In developing OTC derivatives reform legislation, EEI's membership and 69 other organizations[2] believe that effective legislation should accomplish the following:

- Provide a clear statutory exemption for end-users of OTC derivatives products, such as electric and gas utilities that use OTC derivatives markets to hedge against commodity price risk for natural gas and wholesale electric power;

- Promote clearing of standardized derivatives between large financial dealers, where appropriate, through regulated central counterparties to reduce systemic

[1] *See* October 20, 2009 letter to Members of the U.S. House of Representatives from the Coalition for Derivatives End-Users.
[2] *See* November 20, 2009 letter to Senators Dodd, Lincoln, Shelby and Chambliss from EEI, EPSA, AGA, and other supporting organizations (attached).

risk and bring additional transparency through information sharing regarding pricing, volume and risk. However, we oppose mandates that would require all or most OTC derivatives transactions to be centrally cleared or executed on exchanges;

- Promote greater regulatory oversight and transparency of OTC derivatives through increased transaction reporting and authority to the CFTC to prevent manipulation of the derivatives markets;

- Promote the harmonization and clear delineation of regulatory authority and functions among the Securities and Exchange Commission (SEC), CFTC, FERC, and other Federal agencies to ensure similar products are governed by similar standards. In particular, all regional transmission organization (RTO) or independent system operator (ISO) products and services provided under FERC-approved tariffs and oversight (or Electric Reliability Council of Texas (ERCOT) tariffs approved by the Public Utility Commission of Texas (PUCT)) should be exempt from regulation by the CFTC; and

- Amend the proposed definition of a swap to ensure that financially settled physical transactions are excluded from the definition of swap.

As an electric and natural gas utility, we at Exelon look at the impact of the pending legislation from the perspective of our customers, who are electric and natural gas consumers. We certainly support the goal of regulatory reform, but do not support the current version of H.R. 3795, the Over-the-Counter Derivatives Markets Act of 2009, because it would result in costly, duplicative and overlapping regulation over our sector. The balance of my testimony focuses on that problem.

I will briefly describe and explain: (i) why utilities use OTC derivatives products; (ii) the cost to consumers of unnecessary over-regulation of OTC derivatives transactions; and (iii) why FERC has and should retain exclusive jurisdiction over organized electricity markets.

To understand the role of OTC derivatives, I will begin with a short explanation of how organized electricity markets are currently structured and regulated. I have personal knowledge about these markets, both as a former regulator and as a utility executive. Most of Exelon's generation assets and utilities operate within RTOs or ISOs. In fact, over 65% of Americans, or 134 million customers, live in regions served by RTOs and ISOs. These organizations operate the electric grid in their areas and independently administer transmission assets to ensure access to transmission on a non-discriminatory basis. RTOs and ISOs are subject to extensive oversight and also have independent market monitors who certify that these markets are operated fairly and without unmitigated market power. All RTOs and ISOs and the transactions that occur in them currently are regulated exclusively by FERC (except ERCOT, which is regulated by the PUCT).

OTC derivatives transactions are an integral part of how Exelon manages its exposure to price volatility in the electricity markets overseen by FERC and the PUCT. We use OTC derivatives to reduce the price risk which ComEd, PECO, and Exelon Generation face. Our primary objective as a competitive generation company is to manage the revenue risk we would face due to fluctuations in short-term, spot market power prices. This benefits not only Exelon Generation, but also the retail customers served by ComEd and PECO and other local distribution companies (LDCs) to which we sell power. Exelon Generation also hedges some of its input costs (for example, the cost of coal, oil, natural gas, and uranium).

End-use customers benefit from this hedging because it gives their retail providers greater certainty with respect to costs. LDCs and competitive retail electricity providers can offer consumers longer-term contracts locking in prices because they have reduced their risk by hedging their biggest costs. It is our experience that retail customers in particular want prices for power to be stable rather than subject to the fluctuations of the spot market. Without hedging and trading, utilities simply would not be able to ensure stable retail pricing.

H.R. 3795 would make these types of transactions subject to the CFTC's exclusive jurisdiction and apparently would require them to be cleared and/or traded on exchanges. The requirement to clear and/or trade such transactions on an exchange would definitely increase both wholesale and retail electricity prices. Transactions conducted on an exchange are subject to substantial margin requirements; off-exchange transactions do not have the same margin requirements. Thus parties to off-exchange transactions pay less overhead. According to Exelon's analysis, it is very possible a requirement that virtually all trading activity occur on organized exchanges, either through clearing or futures contracts, could increase the power prices we charge utilities and other customers we serve by anywhere from 5 to 15 percent. EEI President Tom Kuhn has stated that the increased costs of making such trades on exchanges would be "astronomical – in the neighborhood of hundreds of millions of dollars annually for an average utility."[3]

Therefore, if H.R. 3795 were enacted as currently drafted, an additional and unnecessary layer of cost would be added to the marketplace. As currently drafted, H.R. 3795 includes a number of terms that are vague or ambiguous that will need to be clarified prior to passage. The bill is intended to focus on the large financial players whose transactions can pose systemic risk. As currently drafted, it is not clear whether utility end-users are intended to also be covered and subject to the various new requirements. Something this important and costly needs to be clear and should unambiguously exempt end users managing commercial risk from the clearing and exchange-trading requirements. Unless the bill's terms are made more precise, determining which parties and transactions are subject to the bill's clearing requirement will be left to the broad discretion of the CFTC. CFTC Chairman Gensler has stated his position that virtually all OTC transactions should be cleared or traded on exchanges regardless of the cost; we respectfully disagree.

[3] See *For Utilities, Derivatives is not a Dirty Word*, Energy Daily, October 7, 2009.

In addition, any proposed legislation should clarify that FERC is the sole regulatory authority governing the organized RTO or ISO markets and the transactions entered therein. We believe that the Federal Power Act (FPA) affords FERC plenary and exclusive jurisdiction over the organized energy markets and transactions, including financial transactions that settle through RTO and ISO systems, both within and between organizations subject to their regulation. Financially-settled transactions are integrally related to the RTO structure and its primary purpose, which is to ensure the efficient and reliable physical generation, transmission, and wholesale delivery of electricity. FERC already understands the details of these unique transactions, while the CFTC has virtually no experience with them. RTOs and ISOs largely evolved from voluntary regional power pools; FERC has 15 years of experience regulating them. They are creatures of FERC's jurisdiction under the FPA and its progeny, including the Energy Policy Act of 2005 (EPAct 2005). EPAct 2005, which originated in this Subcommittee, already provides FERC strong reliability and market manipulation oversight authority.

Because organized energy markets are already pervasively regulated by FERC, we see no reason for duplicative CFTC or SEC regulation in this space. Gamesmanship, abuse and market manipulation all thrive under this kind of overlapping and confusing regulation. Clear and unambiguous authority for FERC to regulate these transactions is essential. There has already been litigation over which agency has authority over wholesale natural gas transactions and natural gas futures contracts and we cannot afford further confusion. In the end, as we all know, it is the consumer who will pay the price.

We encourage the members of the Subcommittee to support amendments to H.R. 3795 that: (1) clarify FERC's plenary and exclusive jurisdiction over RTO and ISO markets and integrally-related financial transactions, and (2) confirm that RTO and ISO markets, and ERCOT, would not be subject to CFTC regulation as if they were NYMEX-like futures exchanges.

While we do not believe that the CFTC should regulate markets already governed by FERC regulation, we do recognize that the CFTC should play an important role in the emerging greenhouse gas markets, where its expertise will provide benefits. The future greenhouse gas market is distinct from energy markets and any proposed legislation should clarify how these new markets will be regulated. In this space, the CFTC has commodities trading expertise that FERC lacks. Generation-owning entities like Exelon, as well as other emitters, will need to procure allowances to comply with greenhouse gas emission caps as we (and other generators) will own covered entities. In this regime, the cost of allowances will be a cost of doing business for generators. It will be just like the cost of gas, oil, coal or uranium – an input that is necessary to enable us to make and sell our product – and Exelon will need to hedge the price risk associated with that product. Exelon will want to have the wide range of options it currently utilizes to hedge its fuel price and power price risks, meaning the full array of both exchange-traded and OTC offerings that now exist. We recognize, however, that in this new market, as in others, there is a need for fair and balanced regulation. No one wants another crisis that could pose systemic risk, or a market structure with continuing regulatory gaps that can tempt unscrupulous traders to manipulate markets and force prices above or below appropriate market levels.

That is why we support the expansion of the CFTC's jurisdiction to the new market for greenhouse gas allowances, including the OTC market that will certainly develop. This, coupled with a price collar for greenhouse gas allowances, which EEI and Exelon support, should allay any concern that speculators could artificially drive up the price of both the derivatives used to hedge the cost of carbon allowances in OTC markets, and the price of the allowances as such. The Commodity Exchange Act already contains strong anti-manipulation provisions that should be made applicable to these OTC markets, and perhaps revised and refined to ensure that they provide the CFTC the tools it needs to police and prevent manipulation in the new greenhouse gas trading markets.

However, in terms of energy markets that are already regulated by FERC, we believe that for the aforementioned reasons, Congress should recognize and preserve FERC's exclusive jurisdiction. Electric and gas utilities engage in risk management transactions in the OTC derivatives markets to help ensure stable and affordable rates for our customers by helping to hedge against price volatility in natural gas and wholesale electric power – two of the most volatile commodities – and already are substantially regulated. Adding CFTC regulation and costly new requirements to this mix will not resolve the issues that Congress wants to address in the wake of the financial crisis, but will serve only to increase energy costs that will ultimately be passed on to our customers. CFTC regulation should be left to areas where their expertise carries benefits, as would be the case in the market for greenhouse gas allowances.

I appreciate the Committee's invitation to testify today and your willingness to examine these issues. I hope that I have provided you with a sense of the impact of duplicative regulation of energy transactions and how it would result in higher costs for companies like Exelon, which in turn would result in higher costs for our customers. I would be pleased to answer any questions you may have.

EDISON ELECTRIC INSTITUTE

epsa Electric Power Supply Association

AGA American Gas Association

November 20, 2009

The Honorable Christopher J. Dodd
Chairman
Banking, Housing & Urban Affairs Committee
534 Senate Dirksen Office Building
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The Honorable Richard C. Shelby
Ranking Member
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The Honorable Blanche L. Lincoln
Chairman
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The Honorable Saxby Chambliss
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The Edison Electric Institute (EEI), the Electric Power Supply Association (EPSA), the American Gas Association (AGA) and our undersigned members are writing to express our concern with certain aspects of proposals to address oversight and transparency of over-the-counter (OTC) energy derivatives markets. EEI is the association of U.S. shareholder-owned electric companies. EEI's members serve 95 percent of the ultimate consumers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the U.S. electric power industry. EPSA is the national trade association representing competitive power suppliers, including generators and marketers. The competitive power sector operates a diverse portfolio that represents 40 percent of the installed generating capacity in the United States. EPSA members use a variety of fuels and technologies to generate electricity, including coal, geothermal steam, hydropower, natural gas, nuclear, oil, solar, and wind. AGA represents 202 local energy utility companies that deliver natural gas to more than 65 million homes, small businesses and industries throughout the U.S., serving 170 million American in 50 states.

While we support the goals of the Administration and the Congress to improve transparency and stability in OTC derivatives markets, it is essential that policy makers preserve the ability of companies to access critical OTC energy derivatives products and markets. Our members rely on these products and markets to manage price risk and help keep rates stable and affordable for retail consumers.

When discussing any increased regulation of exchange and OTC derivatives markets, it is important to note that these transactions are not the source of systemic risk in the broader economy. In fact, the entire commodity market is less than 1% of the global OTC derivative market, and the energy commodity portion is yet a fraction of that one percent. Therefore, Congress should maintain an appropriate balance between establishing market oversight rules that allow for prudent use of market-based risk management tools and providing regulators with the ability to establish a high level of transparency and the tools needed to protect consumers against market manipulation and systemic risk.

Our members believe that effective OTC derivatives reform should:

- **Provide a clear exemption for end-users of OTC derivatives products,** such as electric and gas utilities that use OTC derivatives markets to hedge against commodity price risk for natural gas and wholesale electric power. The hedging transactions of derivatives end-users do not contribute to systemic risk, and, therefore, should be exempted from the definitions of swap dealer and major swap participant.

- **Promote clearing of standardized derivatives between large financial dealers**, where appropriate, through regulated central counterparties to reduce systemic risk and bring additional transparency through information regarding pricing, volume and risk. However, **our members are opposed to mandates that would require all or most OTC derivatives transactions to be centrally cleared or executed on exchanges**. The available evidence shows that clearing would **<u>not</u>** bring pricing benefits that would offset the cost of margining for gas and power derivatives, as some have suggested. In fact, the high cash margin requirements of clearing would significantly increase transaction costs for our members and, ultimately, their retail customers. In addition, it would tie up needed cash at a time when the cost of capital is high, access to capital markets is uncertain, and our industry needs to invest billions in renewable energy sources and new energy infrastructure. As a result, our more capital-constrained members may choose to hedge fewer of their transactions, thereby increasing their risks and passing potentially volatile pricing onto retail customers.

- **Promote greater regulatory oversight and transparency of OTC derivatives through increased financial reporting** and authority to the Commodity Futures Trading Commission (CFTC) to prevent manipulation of the derivatives markets. We believe that this transparency can be achieved in a much more cost-effective way through mechanisms such as a central data repository, as opposed to mandatory clearing.

- **Promote the harmonization and clear delineation of regulatory authorities** and functions among the Securities and Exchange Commission (SEC), the CFTC, the Federal Energy Regulatory Commission (FERC) and other Federal agencies to ensure similar products are governed by similar standards. Accordingly, such harmonization should also work to minimize the burden and cost of compliance with regulatory oversight. As an example, we believe that **all regional transmission organization (RTO) products and services provided under a FERC-approved tariff and subject to regulatory oversight by the FERC should be exempt from duplicative regulation by the CFTC.**

- **Amend the proposed definition of a swap to ensure that financially-settled physical transactions are excluded from the definition of swap.** Amend the proposed exclusion from the definition of swap that currently reads "a non-financial commodity or security for deferred shipment or delivery, so long as the transaction is

> physically settled" to "a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction contains an enforceable delivery obligation." In order to avoid unnecessary costs (e.g., where a party sits in a chain between the producer and ultimate user of a commodity) and for administrative convenience, many physical transactions are settled through a book-out, which is an agreement between two parties to a forward contract to settle their respective obligations with a cash payment, as opposed to making and taking physical delivery. Book-outs have been exempted under CFTC rules since 1993.

Simply put, electricity and gas utilities engage in risk management transactions in the OTC derivatives markets to help ensure stable and affordable rates for our customers by helping to hedge against price volatility in natural gas and wholesale electric power - two of the most volatile commodities. We stand ready to work with you to craft OTC derivatives reforms that enhance transparency and improve overall market functions without creating adverse unintended consequences and increased costs for us and the consumers we serve.

CC: Members of Senate Committee on Banking, Housing, and Urban Affiars

Members of Senate Committee on Agriculture, Nutrition and Forestry

List of Supporting Organizations:

Allegheny Energy, Inc.
Allete/Minnesota Power
Alliant Energy Corp.
Ameren Corp.
American Electric Power, Inc.
Arizona Public Service Co.
Atlantic City Electric
Atmos Energy
Avista Corp.
Black Hills Corp.
BP America, Inc.
Calpine Corp.
CenterPoint Energy, Inc.
Central Vermont Public Service Corp.
Cleco Corp.
Conectiv Energy
Consolidated Edison, Inc.
Constellation Energy Group, Inc.
CMS Energy Corp.
Delmarva Power & Light Co.
Dominion
DPL Inc.
DTE Energy Co.
Duke Energy Corp.
Dynegy, Inc.
Edison International
Empire District Electric Co.
Energy Future Holdings
Entergy Corp.
Exelon Corp.
FirstEnergy Corp.
FPL Group, Inc.
GDF Suez Energy North America
Great Plains Energy, Inc.
Independent Power Producers of New York
New England Power Generators Association, Inc.
Indianapolis Power & Light Co.
Integrys Energy Group, Inc.
International Power America
LS Power
Madison Gas & Electric Co.
MidAmerican Energy
Mirant Corporation
MDU Resources Group, Inc.
Mt. Carmel Public Utility Co.
National Fuel Gas Co.
National Grid
NorthWestern Energy
NRG Energy, Inc.
NV Energy, Inc.
OGE Energy Corp.
Otter Tail Power Co.
Pacific Gas & Electric Co.
Pepco Holdings, Inc.
Portland General Electric
Progress Energy, Inc.
PPL Corp.
Public Service Enterprise Group, Inc.
Puget Sound Energy
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Sempra Energy
Shell Energy North America
Southern Company
TECO Energy, Inc.
Tenaska, Inc.
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Vectren Corp.
Xcel Energy Inc.